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THE RICHEBÄCHER LETTER

Continuing Dr. Kurt Richebächer's Groundbreaking Analysis

NUMBER 405 **JUNE 2008**

Here are the collected croakings of 12 years — the croakings of a Cassandra who could never influence the course of events in time… They were regarded at the time, many of them, as extreme and reckless utterances. But I think the reader, looking through them today, will admit this was because they often ran directly counter to the overwhelming weight of contemporary sentiment and opinion, and not because of their character in themselves. On the contrary, I feel… that they contain more understatement than overstatement, as judged by after events…

Thus, the author of these essays, for all his croakings, still hopes and believes that the day is not far off when the Economic Problem will take the back seat where it belongs, and that the arena of the heart and head will be occupied, or re-occupied, by our real problems… For if we consistently act on the optimistic hypothesis, this hypothesis will tend to be realized; whilst by acting on the pessimistic hypothesis we can keep ourselves for ever in the pit of want.

— John Maynard Keynes, Preface to* Essays in Persuasion, *1931

BEYOND THE TURNING POINT… WELL BEYOND

We are proud to present the first new issue of The Richebächer Letter *since Dr. Kurt Richebächer's passing in 2007. Your new editor, Mr. Rob Parenteau, is committed to expanding on the good Doctor's in-depth criticism and analysis of the world credit markets.*

Mr. Parenteau holds a CFA and spent 24 years as the Chief U.S. Economist and Investment Strategist for RCM Capital Management, an asset management company. In 2006, the highly respected Levy Economics Institute appointed him as a Research Associate. And now he is working for you, attempting to parse the official government numbers to reveal what is really happening in the U.S. economy.

But before he dives in completely, Mr. Parenteau asked for a chance to pay tribute to Dr. Richebächer, and explain how he plans to carry on the good Doctor's important work. I can think of no better way to re-launch The Richebächer Letter. *So please, enjoy!*

Addison Wiggin
Executive Publisher
The Richebächer Letter

I first encountered Kurt Richebächer's work in the late '90s as I was trying to make sense of the asset bubble dynamics then taking grip of the U.S. economy. In 1995, as I was searching for the basis of Japan's stubborn deflation, I finally realized that contemporary macroeconomics — at least mainstream macroeconomics — possessed some very large blind spots. In particular, I realized that the absence of a serious understanding of money, credit and, in fact, a monetary economy as a whole was impeding my own ability to dig beneath the surface and grasp the underlying macro dynamics inhibiting Japan's recovery.

To address this deficiency and remove this blind spot, I found it absolutely necessary to pursue the

original debates between Keynes and the Austrian School that took place over the course of the interwar years and the Great Depression. What I found in the historical debates was both shocking and rich. Clearly, not only was their comprehension of macrofinancial dynamics vastly more sophisticated than the caricatures I had been exposed to (and which most people still associate with Keynes and the early Austrians), but their clarity and insight into real-world economic and financial relationships were also far superior to much of the Wall Street research I was buried in at the time.

For Kurt, economics was a living art and science that deserved to be pursued relentlessly through rigorous, independent, and original thinking and analysis.

Monetary theory — especially the understanding of credit cycles — went decidedly backward after the Hicks/Hansen/Samuelson interpretation of Keynes' General Theory came to rule the very early days of the so-called Keynesian revolution, which proved to be an aborted revolution at best. The understanding of the underlying dynamics of a monetary economy arguably went even further retrograde after Milton Friedman successfully upset the Keynesian consensus in the '70s with his chameleon-like version of monetarist economics. As very few people (even within the economics profession) appear to have read Keynes or the Austrians in the original, much of the wisdom that informed their debate has been lost for the most part to those practicing mainstream macro analysis. This loss seriously handicaps the ability of contemporary mainstream macroeconomic analysis to have any relevance to real-world developments, with the result being the perpetuation of unnecessary confusion and suffering year after year.

When I read my first *Richebächer Letter* in 1997, I immediately recognized that Kurt had undoubtedly steeped himself in the classic works of economics, as well as the debates that transpired on the way into, and throughout, the Great Depression. Years before I chose to undertake a similar, albeit less ambitious, historical recovery and retrieval project, Kurt had rediscovered many of the same vantage points and valuable perspectives locked away in the work of Irving Fisher, John Maynard Keynes, Ludwig von Mises, Friedrich Hayek and other early contributors and acolytes, most of whom were all but forgotten by modern practitioners.

Kurt was clearly a serious macro thinker who also wanted to be taken seriously by the investment and policymaking world. Kurt had not only bothered to do his homework on the history of economic thought and its application to economic history, but he was also always deeply engaged in building on the various insights he had spotted while standing on the shoulders of prior macroeconomic giants. For Kurt, economics was a living art and science that deserved to be pursued relentlessly through rigorous, independent, and original thinking and analysis.

Here was a man who, like Keynes, knew his way around the Kalecki profit equation and understood the importance of profit conditions to macroeconomic outcomes (something that should be obvious in capitalist-driven economies), while most of the mainstream either ignored profit drivers at the macro level or had no conceptual framework for assessing profit prospects at the macro level.

Here was a man who, like Keynes, knew the importance of credit conditions and asset prices to real economic outcomes. Money and finance mattered to real growth outcomes, the path of the unemployment rate and the pace of accumulation of tangible capital like equipment, inventories and structures. Money and finance were not simply veils for so-called real-side conditions like technology, original resource

endowments, and consumer tastes and preferences. Likewise, modern economies could not be understood as simply more elaborate forms of barter economies. In fact, precisely just such an analogy provided a fatally flawed foundation for the Walrasian general equilibrium approaches that came to characterize the basis of sophisticated, modern economic analysis.

Like Hy Minsky, Kurt was clear in his own mind about the fact that persistent deficit spending by any sector of the economy would lead to an unsustainable buildup on the balance sheet of debt — whether it be external, government, corporate or household debt. Like Irving Fisher — at least the Irving Fisher of the 1930s — Kurt knew that in markets for durable assets financed with debt, falling product prices could aggravate the ability of the market to clear. Falling prices for capital equipment, homes or nonresidential structures (as well as financial claims on these same durable assets) could perversely lead to more, not less, excess supply in the market. Lower prices could beget more, not less, desired selling as holders of these durable assets either were forced to sell as their net worth dissolved or were more inclined to sell their holdings of durable assets as their expectations of future spot price levels also dropped further. In this fashion, the price adjustment process for durable assets could drive the economy even farther from equilibrium. Along the way, existing debt loads became heavier and even harder to service as lower prices and lower economic activity resulted in lower nominal income flows for debtors.

Kurt knew the dangers involved in such a debt deflation spiral. Like Ludwig von Mises, he knew not to confuse rising money values of financial claims on capital equipment and structures with an increased accumulation of real wealth — at least in the sense that classical economists like Adam Smith used the word to capture the stock of tangible and accessible productive resources, especially the available productive capacity of a nation. Kurt understood that credit creation and real saving were two separate and often unrelated events, and he saw how the inequality of the two could raise all sorts of havoc in the economy. Like Hayek, he knew the dangers inherent in malinvestment — the gross misallocation or maldistribution of the capital stock — often driven by speculative financial markets or the misguided interest rate policies of central bankers.

Not only did Kurt Richebächer master and apply these various strands of heterodox macro theory, but he was also equally adept at weaving in various historical illustrations to demonstrate the real-world relevance of these conceptual approaches. History was, in a way, his laboratory, and in this laboratory, he employed and upgraded the tools he recovered from prior independent macro thinkers. Kurt's ability to tirelessly chase down the necessary clues, tie them together in a coherent and unique story and then overcome the complexity of it all with brilliant vignettes and analogues from the past packed a punch that had long since left the pages of macro research on Wall Street.

Indeed, by the mid '90s, the role of the strategist, as well as that of the economist, on Wall Street had shifted from one of generating serious and useful analytics, to one resembling more of a client entertainment or broad-based marketing function. A former Fed governor once employed by a now-failed top-tier brokerage house is alleged to have once defended himself in court over some bad interest rate advice to a client by arguing that his work was purely for entertainment purposes, and not to be taken as a serious investment recommendation, or as investment advice of any sort, for that matter. Cocktail party economics, with soothing sound bites designed to fit on the increasingly game show-like format of business- and finance-related TV channels and the associated outright complacency of professional investors in the face of the most unsustainable macrofinancial conditions, came to rule the day. Kurt, in this sense, was a throwback to the past, but a desperately welcome one, at least to the eyes of many readers like you who had the good fortune to discover his monthly take-no-prisoners missives.

Like Keynes, Kurt was not afraid to engage the role of Cassandra, as frustrating and career inhibiting as that repeatedly proved to be. He followed directly where his rigorous and thorough analysis led him, with integrity and humility, regardless of how harsh the truths he revealed along the way. Like Keynes, Kurt felt that the risk of cracking and splintering the thin veneer of civilization in the name of speculation or, for that matter, policy adventuring, was rarely a gamble worth taking. And like Keynes, in retrospect, Kurt's warnings were often discarded by the mainstream as too alarmist, too critical or too early for the time. Ironically, just as Keynes experienced, these warnings usually proved to be understatements of the eventual challenges that arose when policy experiments went horribly wrong or when patently unsustainable macrofinancial dynamics were allowed to run amok.

Kurt's final message to his readers was fully contained in the title of his February 2007 letter, "Approaching the Turning Point." At that time, you may recall, the housing bust was already well in motion. Original professional assessments, promises and reassurances that a mild fire in the more esoteric segments of the mortgage market would be put out immediately, or would at least be eventually contained to that strange corner of the housing finance woods, have since been proven dead wrong. The subsequent implosion of the new financial architecture, with all of its supposedly stress-tested features, has proven nothing short of breathtaking. Consequently, the U.S. economic expansion, which was subpar across many metrics to begin with, has clearly and undeniably derailed, in turn taking prospects for G-7 economic growth lower with it. A recession deeper than most professional investors have experienced may, in fact, already be on our doorstep.

EXTENDING THE PATH

In the aftermath of this unraveling, which Kurt foresaw with his characteristic passion and clarity, policymakers have scrambled with a desperation unseen in at least a quarter century, if not a lifetime. Federal Reserve Chairman Ben Bernanke has not only sliced overnight bank borrowing rates faster than his predecessor ever dared, but he has also introduced a series of institutional innovations to improve the liquidity conditions across a swath of large financial institutions at a breakneck pace. The recent socialization of losses from the former Bear Stearns balance sheet certainly breaks new, dangerous ground in a monetary policy landscape already strewn with far too much moral hazard.

Kurt's keen eye, intellect and grasp of historical precedents, in other words, are needed now more than ever to make sense of the extraordinary unraveling of the new financial architecture. In this and subsequent monthly letters, every effort will be made to bring to bear the key tenets of Kurt's ever insightful analysis on the challenging situation at hand. Here are some of the areas I intend to explore in upcoming issues:

- I will expose the implicit exit clause in the Fed's Taylor rule, which is used to summarize its approach to achieving its purportedly pre-eminent goal of inflation stabilization. In addition, I will investigate the sheer folly of the Fed's professed asymmetric approach to asset bubbles. The Fed, I will argue, appears to be locked into an unfortunate policy game of generating (or at least allowing) serial asset bubbles. However, contrary to popular perceptions and financial press accounts, the Fed has yet to flood the system with liquidity this time around, perhaps because it remains somewhat constrained by rising commodity prices, a falling dollar exchange rate and rising household inflation expectations. In contrast to current consensus views, the Fed is more likely to find itself pushing on a string, given the need for many major financial institutions to adequately recapitalize themselves as they take major write-offs and losses.

- I will show how a purely "blame the Fed" approach may be somewhat misguided. As you'll see, the new financial architecture, which relied more on financial market-centered credit creation and distribution than the previous bank- centered system, held enough built-in design flaws, starting with some rather perverse incentive structures for professional investors, bank loan officers and creditors in general, that sooner or later it would have imploded, with or without the Fed. The Fed's tightening trajectory in the last cycle was one of the most incremental and predictable ones on record. The housing bust had less to do with Fed tightening and more to do with the inevitable collapse of what amounted to an increasingly Ponzi finance and massive fraud-driven asset bubble. Investors are likely to recognize that Humpty Dumpty cannot be put back together again, but undoubtedly he will be massively reregulated.

- I will investigate what it may take to revive U.S. profit conditions. Specifically, the relevant question is, can the fiscal and trade balances turn swiftly enough to overcome the drag from household and business spending? The evolving credit crunch and negative wealth effects developing in recent quarters are likely to reduce, if not reverse, the ability of the private sector to deficit spend. Despite all the talk of global decoupling, an attempt by the world's largest trade deficit nation to get back to a trade surplus position may end up simply disrupting growth in the many countries currently pursing export-driven development strategies.

- I will demonstrate why markets in durable assets (especially capital equipment and structures held with leverage) may not adjust in the same smooth, automatically equilibrating textbook fashion as, say, the market for Chiquita bananas or other short-lived nondurable consumer goods, which tend to be purchased most frequently by households. This inherent design flaw in durable asset markets was once well understood by the likes of Minsky, Keynes and Fisher, but got lost (or, more likely, intentionally buried) rather quickly in the subsequent development of modern mainstream economic theory.

Despite all the talk of global decoupling, an attempt by the world's largest trade deficit nation to get back to a trade surplus position may end up simply disrupting growth in the many countries currently pursing export-driven development strategies.

- I will explore the likely adjustment process for the external trade balance accounts, and I will further detail what this adjustment process means for U.S. dollar prospects. Contrary to conventional wisdom, the U.S. trade deficit is not the twin of the U.S. budget deficit but rather the twin of U.S. household deficit spending. In fact, the United States may never have been dependent upon foreign saving to "finance" its trade deficit. For example, no U.S. household was dependent on a U.S. dollar-denominated loan from a German bank before purchasing a German-produced BMW. For starters, foreign banks cannot create U.S. dollar-denominated loans out of the blue. The actual credit creation instead came from U.S. financial institutions expanding their balance sheets. In a credit money currency system, with a sovereign currency, this balance sheet expansion process does not, oddly enough, require a prior act of saving. But the entire process certainly was dependent upon favorable foreign portfolio preferences that kept the ever-mounting pile of U.S. external liabilities placed at a manageable price, and therefore at low enough yield to encourage record U.S. private sector

deficit spending.

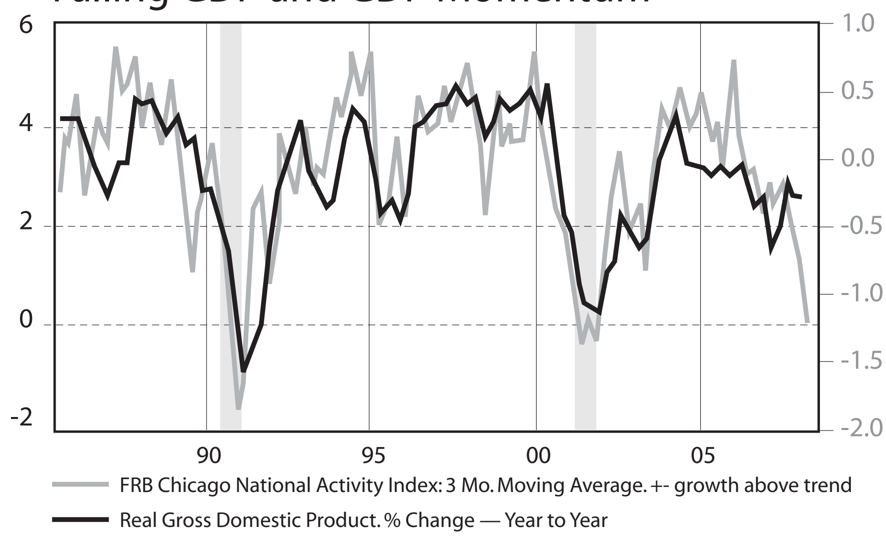
- In a related vein, I will look deeply into the inflation process and examine whether the current food and price shocks, along with the multiyear depreciation of the U.S. dollar, are likely to overwhelm the deflationary impulses rippling out from the housing bust and the now seriously impaired credit system. In particular, I will show it is difficult to sustain a period of accelerating inflation, or persistent stagflation, without either a complementary increase in labor's bargaining power or a strong expansion of credit growth. Rising final product prices cannot be easily sustained if households lack the necessary income growth or credit availability to validate continually rising prices. To this point, even Milton Friedman was very clear that unless money is spent, it is difficult for an expansion of the money stock to lead to higher inflation. There is no invisible hand, anonymous auctioneer or other transmission mechanism that immediately equates a larger money supply with a higher final output price level. In this sense, the monetarist equation of exchange, whereby MV = PQ (the money supply times the velocity of circulation of money equals nominal GDP) is either incomplete or, more likely, an empty and not terribly useful truism.

In all cases, I will bring the full power of Kurt's unique analytical approach to bear on these questions. My objective here is to keep the line of research Kurt pursued for his entire professional life alive. In fact, it is evolving quickly and broadly enough that it remains extremely relevant to making sense of the macrofinancial challenges in the days, weeks, months and years ahead. My hope is that you, the reader, may continue to take advantage of the powerful insights of this great man, even well after his passing. If my efforts, and the efforts of others at Agora Financial, are successful, Kurt may finally get the long overdue recognition of his remarkable contribution to a sound, reasonable and deeply relevant real world macroeconomics — a development that is sorely needed.

A MISGUIDED MOPING ABOUT STAGFLATION

Kurt no doubt would be amused to see that over the past two quarters, as the housing implosion has gathered steam, taking the economy and financial markets with it, the consensus of economists has moved decidedly into a mildly stagflationary frame of mind. Stagflation — the combination of economic stagnation, perhaps even recession, with escalating inflation — is, you may recall, one of the worst macro environments for financial asset returns. This stagflationary frame of mind is shared by equity, currency and commodity investors, but perhaps less so bond investors, who are still discounting more of a recession result than their colleagues in other asset classes. Kurt's final concluding paragraphs indicate his chips would be with the bond investors, as he wrote quite astutely:

Falling GDP and GDP Momentum



> *It is no big secret that for several years the American consumer, with his*

unprecedented borrowing and spending excesses, translating into record-sized U.S. current account deficits, has played a key role in driving global economic growth… Right now, there exists enormous faith in the ability of the Federal Reserve to keep the various asset and credit bubbles inflated. Inflationists fail to see that much of the credit being borrowed can never be repaid.

Surprisingly, or perhaps predictably, by March 2008, for all the talk by investors and economists of global decoupling (despite no evidence of the same in global equity markets in recent months), the consensus of economists had pretty much the same 1.5% (or thereabouts) real GDP growth expectation for all G-7 countries in 2008. This is a bit odd, given the prevalence of recession signals in Japan and the United States relative to those few coming out of the United Kingdom and Europe, but having worked in the business for a quarter century, I am well aware of the tendency for many Wall Streeters to seek safety in numbers. Economists herd just as much as equity investors or relative performance fund managers, or for that matter, hedge fund professionals. Regardless, on the Chicago Fed's own monthly proxy for real GDP momentum, which is comprised of some 85 independent economic data series, there can no longer be any question that the United States has entered a full-blown recession.

Not surprisingly, professional long-only equity investors and sell-side equity analysts who failed to see recession coming, or even denied a recession could possibly arrive, are already busy trying to call the bottom. This, of course, is a required condition for them to begin to look through the proverbial valley and discount a prospective second-half 2008 or early 2009 economic reacceleration. No attempt is made by these same characters to explain why the housing bust and the subprime mess failed to remain contained, as they had previously asserted, from infecting the larger economy and financial market conditions. Such errors of professional judgment are apparently best left unexamined. Conveniently, contemporary Wall Street acts as if errors left unacknowledged, like falling trees in abandoned forests, never really happened. It is as a sort of required Alzheimer's that comes with the territory.

In contemporary mainstream macro views, policy intervention is primarily a monetary, not a fiscal, exercise, and monetary policy is believed to work by managing and manipulating private sector agent expectations, especially investor expectations, such that asset prices lift enough and interest rates fall enough to encourage renewed consumer spending and reignite entrepreneurial activity. The key countercyclical policy lever to pull for at least the past two decades has resided at the Fed, and the transmission mechanism for the Fed is now openly recognized to run straight through financial market prices, onto private agent expectations and, finally, onto changed private sector spending behaviors, whether in the form of renewed capital spending plans or improved consumer spending.

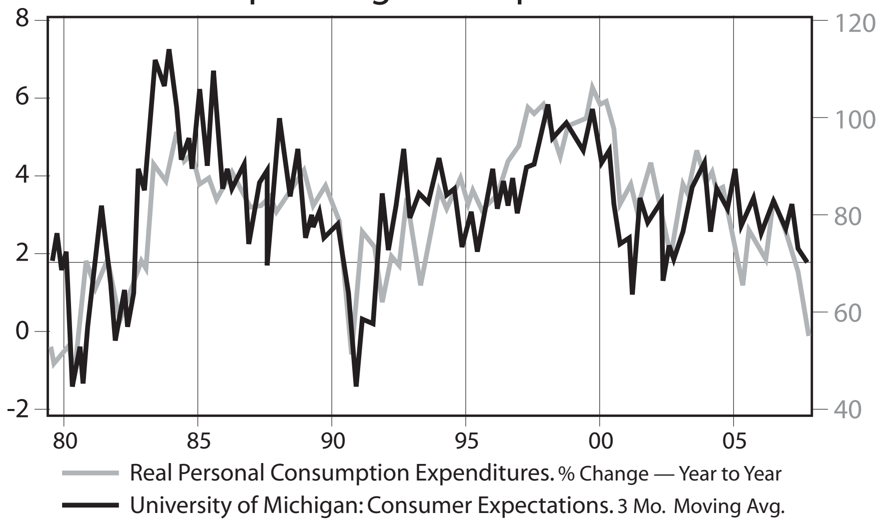
The bad news is we are not yet at prior business cycle troughs for consumer expectations, and the asset price that matters the most this time around for economic stabilization, namely home prices, is showing little or no signs of getting any traction yet

If this characterization of conventional macro wisdom is largely correct (even though it is not made very explicit in concise Taylor rule formulations, it is clearly found in Fed governor speeches, as well as in contemporary academic literature), one way to tell whether the Fed has done enough in the realm of monetary policy easing — which perhaps can be best summarized by cuts in the fed funds rate — is if the expectations of U.S. consumers have begun to stabilize and improve. In fact, the expectations component of the monthly University of Michigan

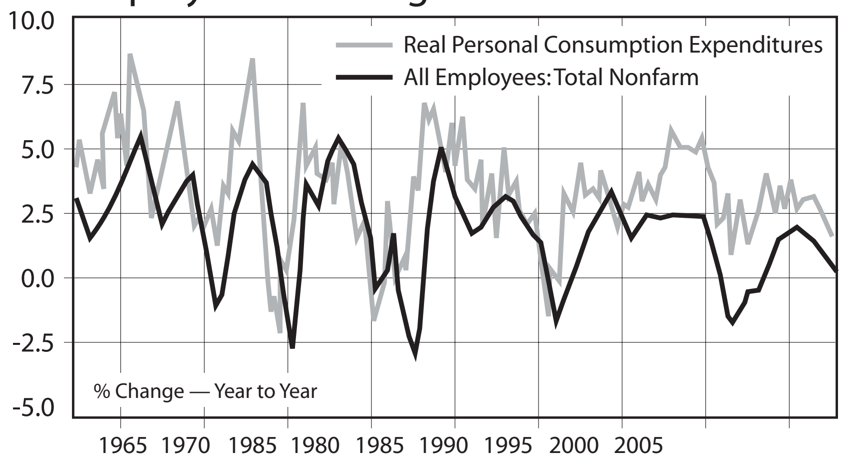
consumer survey has provided a reasonably good guide to real consumer spending, a major element in determining real GDP momentum.

Consumer expectations are still nose-diving as of the latest April and May readings. That is somewhat surprising, given the rebound in equity prices of late, as well as the contraction in credit spreads since the Fed took an investment banking- and private equity-like position with Bear Stearns, which was subject to a modern-day version of what was once known as a run on the bank. The bad news is we are not yet at prior business cycle troughs for consumer expectations, and the asset price that matters the most this time around for economic stabilization, namely home prices, is showing little or no signs of getting any traction yet, as will be discussed in more detail later.

Consumer Spending and Expectations in Decline



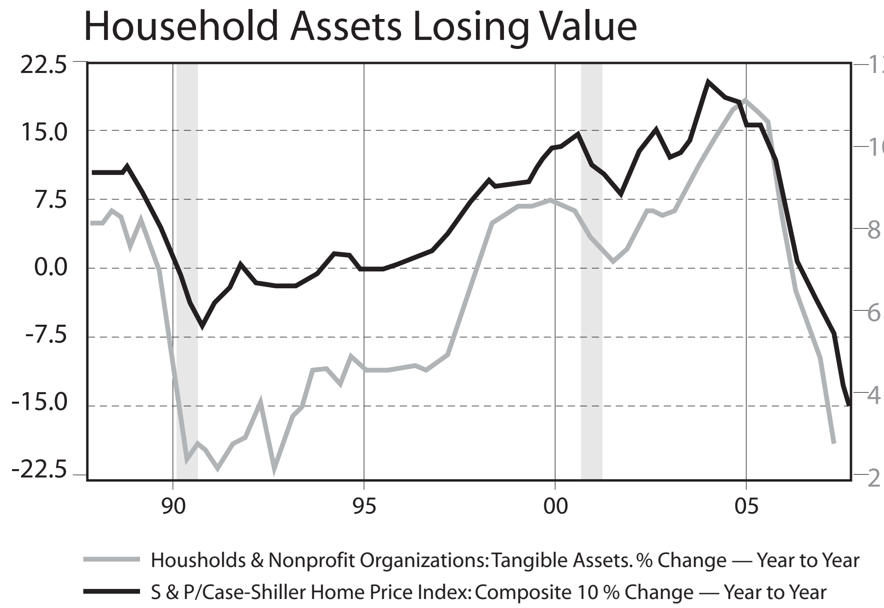
Employment Falling



Once consumer spending growth drops below 2% in the United States, it is usually quite difficult to avoid a recession. Usually, an adverse feedback loop develops in the early stages of a recession among slower consumer spending, weaker revenue growth and profitability among consumer sector companies. Then consequent employment cuts will develop, thereby disrupting wage and salary income growth, leading to further consumer spending slowing. As displayed in the chart above, there is no doubt we have just entered precisely that vicious cycle. Judging by the profile of employment growth in prior recessions, the harshest segment of this vicious cycle still lies ahead.

HOUSING FIFO: FIRST IN, FIRST OUT?

Ultimately, the litmus test this time around for whether the economy is about to right itself is whether home prices stabilize and whether expectations of forward home prices sufficiently exceed current spot prices. In order to stabilize housing, expected returns on real estate holdings must compensate investors and owners for the risks they perceive they are taking in owning this asset class. Actual spot and expected future prices must adjust such that portfolio preferences shift sufficiently in favor of tangible real estate assets. Otherwise, the market will continue to try to clear through falling home prices until the value of housing in portfolios shrinks to the desired lower share of the total portfolio value.



Of course, asset price stabilization is unlikely to be a sufficient condition for an economic revival. Income growth expectations must also improve enough that mortgage servicing concerns abate and lender stringency starts to dissolve. Household income expectations are unlikely to settle down until businesses have exhausted their labor shedding (which they have only just begun in recent months) and policy provisions, like tax cuts, have become large enough to overcome the so-called credit headwinds. Presently, household net expectations about income growth are at the lowest levels experienced in over 35 years of survey results. In the meantime, as will be developed in subsequent letters, keep in mind that perverse price adjustment dynamics can plague markets for durable assets, especially those held with lots of leverage. Lower prices, in such markets, often beget more, not less, net excess supply.

In terms first used by John Hicks, a contemporary of Keynes, if the elasticity of expectations is high enough, falling prices will encourage expectations of even lower prices in the future. This response encourages existing holders of durable assets to attempt to sell now, rather than wait to sell later. Falling prices don't clear such markets — they simply glut them with more excess supply, begetting even lower prices in a vexing, disequilibrating fashion. In the extreme, a vicious Fisher/Keynes/Minsky debt deflation spiral can result, threatening wholesale bankruptcy and widespread financial failure, if not the collapse of the nation.

The S&P Case-Shiller home price index, which is perhaps the cleanest, apples-to-apples housing price series available, is already showing a much deeper deflation than the 1990 recession — and remember, this economic recession has only just begun. Yet in the Fed's own flow of funds series, tangible asset values are still expanding, albeit at a pace close to the 1990 recession. This discrepancy doesn't make much sense — odds are that household net worth is already decaying faster than the Fed's data are reflecting.

We are only just at the onset of the financial wealth contraction process, and if the prior historical pattern holds, we are unlikely to see the household saving rate fall much further

We are only just at the onset of the financial wealth contraction process, and if the prior historical pattern holds, we are unlikely to see the household saving rate fall much further. In theory, the household saving rate should actually rise, as more money must be saved out of paycheck inflows in order to achieve any given saving goal if the stock of household wealth is not appreciating as fast as previously, or even shrinking, on falling asset prices. The drag on consumer spending growth, then, has an asset value component as well as a labor market one. The brunt of these headwinds to consumer spending still lies ahead,

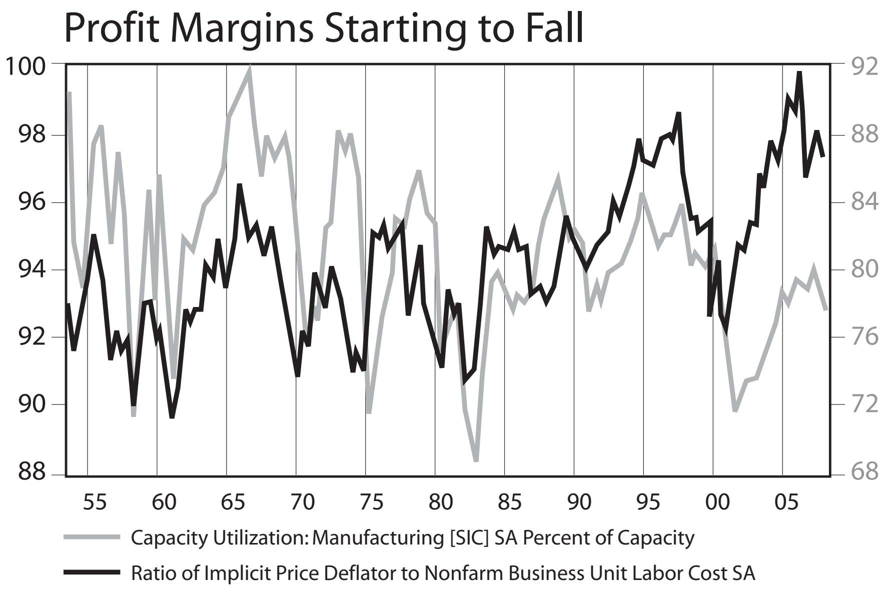
and a temporary tax rebate is unlikely to be able to overcome these adjustment dynamics for more than a quarter or two at best — if that, given the vicious oil and energy price hikes in recent months.

If home price stabilization is one of the keys to righting the U.S. economy, it is important to wade upstream and examine home buying attitudes, inventory trends and builder perceptions. We will know when home price deflation and mortgage rates have dropped enough to make a difference when the level of inventories of unsold homes and the homeowner vacancy rate both begin to stabilize and shrink.

Along these lines, households have recently been reporting to the University of Michigan survey that home buying conditions are stabilizing and improving, while the National Association of Home Builders composite is also showing a perceived stabilization of housing market conditions by the builders themselves. Of course, forced asset sales by ramped-up foreclosure activity could very well tip the balance back down again in the months ahead, so this situation deserves close monitoring. Nevertheless, there are at least a few favorable straws in the wind, most of which have been ignored by the financial press to date.

STAGFLATION OR PROFIT SQUEEZE?

Markups of prices over unit labor costs are failing — a sign of faltering final demand growth, and also a sign that the recent mild stagflation episode will prove short-lived.



Falling markups usually indicate falling profit margins, as displayed in the chart to the left. Falling profitability, in turn, is a signal to managers and entrepreneurs that they need to reduce utilization rates of existing productive capacity. With capacity utilization and markups falling, the rationale for capital spending growth now relies almost entirely upon introducing the unit cost-cutting benefits of new production technologies.

As it stands, U.S. corporate profit margins are contracting as final product price inflation decays faster than unit labor costs. Falling profitability is generally not conducive to positive or favorable CEO expectations, and falling profits and falling CEO expectations both tend to weigh heavily on capital spending plans.

Core inflation is, at least on the Fed's preferred personal consumption expenditures (PCE) metric, back below the 2% ceiling on a year-over-year basis. Headline inflation is also cresting, and unlike the stagflationary 1969–1981 period, core price inflation has not followed headline inflation up in a nearly one-for-one fashion this time around. Odds are any stagflation will prove mild as the recession further erodes pricing power and continued food and energy price shocks eat away at profit margins.

The fact of the matter is that final product price inflation received by nonfinancial corporate business peaked shortly after housing peaked two years ago. Unlike the stagflationary '70s, this measure of the inflation rate will no doubt show a decelerating trajectory as this recession unfolds. That rules out a stagflation

outcome, and it certainly rules out an accelerating inflation outcome. Similarly, there is no wage/price spiral at work this time — a crucial ingredient in the '70s stagflation episodes — because in a globalized labor market, labor's bargaining leverage is simply nowhere to be found.

MONETARY ESCAPADES & SHENANIGANS AT CASINO ROYALE

Chairman Bernanke has now outdone the Maestro, Sir Alan Greenspan, in terms of the speed and size of the monetary policy ease in response to both weakening economic activity and imperiled financial market conditions. In addition to moving swiftly on the conventional monetary policy front of fed funds rate cuts, the chairman has not been in the least bit shy about unveiling several new unconventional policy responses, each one building on the prior one. From an economic perspective, the Fed is unlikely to be ahead of the curve yet, but at least it has been scrambling faster than usual, and with its ingenuity fully engaged.

The real fed funds rate — the stated nominal fed funds target rate, minus the year-over-year rate of change of the core (that is, excluding food and energy) inflation measure for personal consumption expenditures — which in conventional theory is the one that matters most to real GDP growth outcomes, is nearly negative. Note that in all prior recessions over the past half century, this degree of monetary ease was not achieved until after the recession was nearly done, or until after it was completely over and the early recovery was under way. So the Fed has eased faster than usual, but undoubtedly given the enormity and complexity of the macrofinancial imbalances that must be addressed, it, in fact, needed to move swiftly and decisively in order to avoid a financial crisis.

There is a pushing on a string element at work, however, as nominal interest rates in the credit markets that matter the most to private sector growth prospects have not fallen as swiftly as the fed funds rate was cut. Many mortgage rates are barely off their prior highs, despite 325 basis points of fed funds rate cuts. To be sure, this widening of net interest margins is also the mechanism by which banks become incentivized to renew lending.

At some point, net interest margins will become wide enough to cover required risk premiums, and senior loan officers will begin lending again. Their marching orders, however, for the foreseeable future will insist on tighter lending criteria than most firms and businesses have seen in over 15 years. As an illustration of this, note the conversion rate of mortgage refinancing applications, which have been escalating since the turn of the year, into actual bank real estate loans remains minimal at best.

> ***Given the size of the financial mess on hand, however, and the extraordinary imbalances going into this recession, signals of such stabilization in the macro and financial data flow are unlikely to arrive soon***

SUMMARY AND CONCLUSIONS

As Kurt adequately and earnestly forewarned over a year ago, recession and financial instability dynamics are now visibly under way in the United States in the wake of one of the largest asset and credit market bubbles in history. The relevant question now becomes how long and how deep will the economic damage be as this vortex of instability spins out in a widening arc? Fiscal and monetary policymakers are pulling out all the stops to contain the damage, but the scale, scope and

sheer complexity of some of the challenges they face are truly daunting.

Stabilizing housing prices and stabilizing and improving credit market conditions remain two key elements in any successful turn around. Given the size of the financial mess on hand, however, and the extraordinary imbalances going into this recession, signals of such stabilization in the macro and financial data flow are unlikely to arrive soon, even though professional investors have been jumping all over themselves to declare the bottom is already in and the valley of economic recession needs to be "looked through." Such Prozac moments are truly endearing, and will no doubt be repeated several times in the quarters ahead.

In upcoming letters, I will demonstrate the value of Kurt's unique macrofinancial approach in identifying the necessary and sufficient conditions for the United States to return to a reasonable growth path, as well as in assessing whether we are moving closer to meeting those conditions. Our goal is to keep the best of Kurt's insights alive and evolving in the years ahead. Perhaps there is no better way of honoring the memory of such a great man.

THE RICHEBÄCHER LETTER

In Memory of Dr. Kurt Richebächer

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